

SETTING A NEW COURSE for Arizona's Fiscal Future

A Principled and Strategic Approach to
Economic Growth and Development



**A Presentation to the
Citizens Finance Review Commission
by the Arizona Education Association**

July 10, 2003

The mission of the Citizens Finance Review Commission is to develop a series of recommendations that will advise the Governor on a course to stimulate Arizona's economy for the long term. In particular, the Commission will develop recommendations that address fiscal and tax policies that are simple, low and fair and support Arizona's growing economy.



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INTRODUCTION

Arizona is a state, like many others, without a well-defined and strategic fiscal system. Instead we have fiscal policies that have been created in reaction to events over time. The lack of strategic thinking has resulted in a tax system that the Morrison Institute for Public Policy describes as “a revenue sieve . . . old and full of leaks.”¹

The Arizona Education Association holds great hope for the work that has been charged to the Citizens’ Finance Review Commission by Governor Napolitano. The AEA believes that Arizona will continue to be limited in reaching its potential unless leaders of all sectors from our state see themselves as contributors to an overall strategy that sets us on a course to grow Arizona’s economy for the long term.

Such a strategy must be based on a shared understanding of our current fiscal status. A common agreement about the state of our fiscal policies provides a basis for moving to a preferred future. Such a future needs to be defined by a set of principles and practical fiscal components that will generate widespread excitement and commitment to their realization among our state’s leaders.

A strategy must be defined that incorporates specific steps, over time, that Arizona’s leaders can take to garner the support of its citizens that will be necessary to realize such a vision. The strategy should include a calculated immediate action to stimulate growth in the Arizona economy.

Such work must consider all aspects related to taxes and government spending as part of one system. One cannot be considered without the other since Arizona’s constitution requires a balanced budget.

To focus too much on taxes without considering the requirements placed on our state and local governments by Arizona citizens removes consideration of half of an economic development strategy. We must seek to create a system of spending and taxation that invests in our social infrastructure, creates a high quality of life, and promotes business growth and expansion. To focus too much on spending without consideration of taxes is irresponsible.

This report represents AEA’s contribution to the development of a comprehensive fiscal strategy that sets a course to grow Arizona’s economy for the long term. It will contain recommendations that demonstrate our willingness to contribute in hopes that other leaders in our state will approach this endeavor with a similar attitude of stewardship.

¹ Morrison Institute for Public Policy, Arizona State University. *Five Shoes Waiting to Drop on Arizona’s Future*. October 2001. (p. 5)

ARIZONA'S FISCAL STATUS

Arizona's structural deficit has been masked by the cyclical nature of the economy. The structural deficit and economic cycles must each be understood and addressed through the development of a logical fiscal system for Arizona.

STRUCTURAL DEFICIT

The fiscal outlook for Arizona state and local governments depends on two basic factors: (1) its revenue system – that is, what it taxes and the level of those taxes (to a lesser extent the fees and other charges Arizona imposes and the amount of federal dollars it spends). And, (2) the factors that drive what it costs to keep doing what Arizona government needs to do – for example, how fast school enrollment, health care costs, or population will grow.

Arizona shows a serious structural deficit because it has built-in factors that will cause state and local government spending to grow faster than state and local government revenues. Arizona is projected to have a level of state and local government spending that is 16.6 percent greater than projected state and local government revenue through 2009. This projected disparity of 16.6 percent ranks 49th among the 50 states. By the year 2009, Arizona's current fiscal system would represent a structural deficit of slightly over \$5 billion.²

A structural deficit can be resolved through modifications to the fiscal policies of the state. Such modifications need to result in a more elastic system that is balanced by stability. The right mixes of a progressive income tax, a stable property tax, and a broad range of consumption taxes characterize such a system.

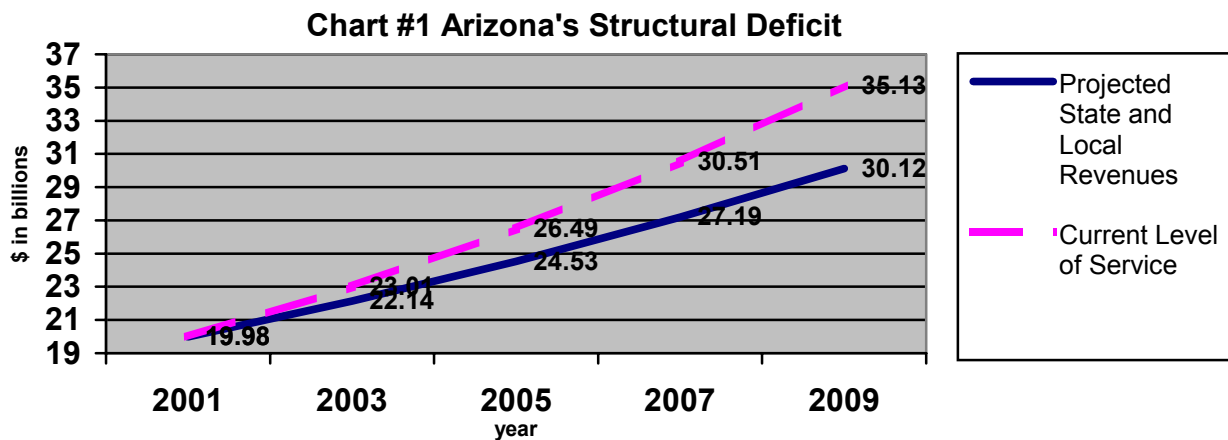


Chart #1 represents the projected structural deficit using 2001 as the base year. The spending projections to determine the projected level of services assume that there will be no quality improvements or erosion in government services. The revenue projections assume that there will be no change in the

² National Education Association Research Division. *State and Local Fiscal Profiles*, March, 2003.

current tax rates or in the type of taxes and charges currently used by Arizona. A major factor in the underlying cause of this relatively high structural deficit is the lack of elasticity value (how well the state's tax structure captures revenue from economic growth) of our state's tax structure. Arizona's elasticity value is 96.4. In other words, Arizona tax revenue will increase 9.64% for every 10% increase in state personal income. Projected spending increases to provide the current level of services in key areas rank from 2nd to 7th in the nation due to population growth and demographic trends.

CYCLICAL EFFECTS

In March of 1999, the Arizona Education Association hosted a presentation by a respected economist, the late Dr. Hal Hovey, to leaders of the state's private and public sectors. At the time, the economy was booming and news about Arizona's state and local taxes could not have been better. Tax collections were significantly exceeding expectations and spending pressures were mild due to reduced welfare caseloads and slower than expected increases in health care spending. Dr. Hovey warned Arizona about its structural deficit that was being masked by an extreme cycle of economic growth and the importance of not planning based on the inflated revenue numbers.

Cyclical deficits arise out of recessions. They cause reductions in the rate of revenue growth coupled with higher costs for safety net programs driven up by rising unemployment. Often cyclical deficits call for targeted government spending increases in areas that hold high public value and are labor intensive to stimulate economic growth.

Arizona is experiencing such a cyclical deficit, but again, it should not serve to mask the underlying structural deficit. Cyclical deficits should be counterbalanced with an adequate revenue surplus or rainy day fund.³ Although Arizona established a budget stabilization fund in the early 1990s, it was depleted in order to reduce tax rates and fund a solution to the alt-fuels fiasco, leaving little surplus to help us through the current economic cycle. The tax-rate reductions of the booming 1990's have factored into Arizona's current structural deficit.

LACK OF A LOGICAL FISCAL SYSTEM

Arizona has no logic to guide its fiscal system. Instead, such policy decisions are made in reaction to events. Spending is restrained due to political pressure to reduce taxes manifested in the legislature. Voters initiate spending mandates through the ballot for education and health care to counteract the legislative policies. The economy is good so taxes are reduced. The economy is bad, so there is pressure to raise taxes. One event after another drives fiscal policy.

A high quality fiscal system is established through the development of an overall vision of how government needs to serve the economic development of a state and the needs of its citizens. In fact, serving the needs of citizens by improving the quality of their lives is an important part of an economic development strategy. Such a system balances the parts of the system by creating an appropriate reliance of income taxes, property taxes, and consumption taxes so the system grows with the economy while keeping the amount of money in the private sector at an economically productive level.

³ Hovey, Hal. 1998. *The Outlook for State and Local Finances*. National Education Association, Washington, D.C.

A HIGH QUALITY FISCAL SYSTEM DEFINING THE TARGET

Ready, aim, fire – not, ready, fire, aim. This phrase describes the fundamental shift in Arizona's thinking about fiscal policies that need to occur. Arizona leaders need to reach consensus on what we are aiming for as a tax and fiscal system is designed. A vision for Arizona's system needs to be created that addresses three main components – (1) Economic Growth, (2) Economic Development, and (3) Principles.

ECONOMIC GROWTH

The level of economic growth enjoyed by our state will to a great degree measure the success of a quality fiscal system. Understanding the relationship between Arizona's fiscal policies and economic growth is primary.

What is the optimal size for government? Which fiscal measures produce the most positive effect on economic growth? As Arizona considers fiscal measures to stimulate economic growth and as an overall strategy for continued economic growth is developed, it is important to keep both of these questions in mind. Simplistic ideological answers will not serve us well and should be isolated and avoided. Advocacy groups calling for increased government spending, on one end, as an answer for every economic problem and those claiming that reduced taxes is always the answer, on the other, should be challenged.

What is the optimal size for government? Too much spending and the resultant level of taxes limit private sector economic activity. Too little government spending results in a lack in development of infrastructure, human capital, and services that support conditions for economic growth. A quality fiscal system should be designed to create the optimum level of taxes to provide the quality level of services required to support economic growth without overspending that drains the private sector of capital.

Which fiscal measures produce the most positive effect on economic growth? Fiscal measures are often used to stimulate an economy. A reduction in taxes frees up money for investment in the private sector – creating jobs that produce economic growth. Government spending on desired services that are labor intensive creates jobs that produce economic growth. Economic growth produces more government revenue. The types of taxes increased to support services or reduced to stimulate private sector activity or types of government jobs created also factor into choice of fiscal measures to implement.

ECONOMIC DEVELOPMENT

Economic development is the ability to create an environment that enhances the growth of the economy. Improving the quality of life for citizens is just as important as a competitive tax structure for businesses.

Factors such as **labor force** (workforce preparation, accessibility, cost); **infrastructure** (accessibility, capacity, and service of basic utilities, as well as transportation and

telecommunications); **business and community facilities** (access, capacity, and service to business incubators, industrial/technology/science parks, schools/community colleges/universities, sports/tourist facilities); **environment** (physical, psychological, cultural, and entrepreneurial); **economic structure** (composition); and **institutional capacity** (leadership, knowledge, skills) are enhanced to attract jobs and businesses.⁴

According to the U.S. Department of Commerce, Economic Development Administration, there are six emerging policy issues that a quality economic development strategy addresses.⁵ These six issues need to be addressed in an Arizona Fiscal Strategy.

1. Educational quality and workforce preparation will become increasingly critical.
2. Changes in information technology, communications technology, and the growth of the Internet will have a major impact on the economic development profession.
3. Existing business development will be central to economic developers in the years ahead.
4. Economic developers will have to know more about global markets.
5. The ability to forge political consensus within a community will be critical to successful economic development efforts.
6. Because of the scale of investments needed and the speed of economic change, the New Economy places a premium on collaboration. No one can afford to go it alone.

How does this translate in Arizona? A leading high tech corporation used the following criteria in its site selection process before moving to Arizona.

- Stable, cost-competitive business climate that promotes exports, capital investment, and innovation
- Educational partnerships for skilled workforce, research & development, and for family quality of life
- Efficient transportation infrastructure for movement of employees and goods, with international reach
- Clean air, water, and reliable energy resources

Such business requirements must be considered as a fiscal system is developed. A key target of our system must be creating such an environment. To hit the economic growth, quality of life, and economic development target, a strategy must be guided by a set of principles that serve as guideposts for policy makers.

PRINCIPLES

Any strategy must be principled. Principles guide policy development. The National Council of State Legislators has developed a state-specific and widely supported set of fiscal system principles (below). The National Education Association has adopted similar principals (Attachment 1). Arizona needs to adopt its own principles and use them.

⁴ U.S Department of Commerce, Economic Development Administration.
<http://12.39.209.165/xp/EDAPublic/Research/EcoDev.xml>

⁵ American Economic Development Council, Economic Development in Today's Economy: A Toolbox Publication from AEDC, 1998, pp.12,15.

Fiscal System Principles⁶

- **Operate as a logical system** – The parts of the system are complementary and include an overall vision of how all parts relate to one another. Local and state taxes are viewed as one system in order to counteract the regressivity of most local taxes.
- **Produce revenue in a reliable manner** – Revenue must be stable. A well-endowed rainy day fund and adequate reliance on more stable tax sources improve reliability. Certainty is a result of a reliable system, thus avoiding constant tax rate changes. Sufficient revenue to fund the level of spending that citizens want and can afford is another feature of a reliable system. In other words, taxes whose revenue grows relatively slowly should be offset by taxes that tend to grow more rapidly than income.
- **Have diversification of revenue sources over broad bases** – Six sources raise substantial revenues – the general sales tax, the personal income tax, the property tax, excise taxes, business taxes, and user charges. Diversification allows the rate on each to be low. Diversification balances the negative aspect of each individual tax.
- **Shield subsistence income, not be regressive, and impose a similar tax burden on households with similar incomes** – The regressivity or progressivity of any particular tax is not as important as the burden of the entire tax system. Despite debate over the definition of fairness, the system should at a minimum meet this standard.
- **Minimize compliance and administrative costs** – Some complexity is necessary, but complexity should be tolerated only to the extent it is needed to achieve the overall principles. Compliance should be easily obtainable.
- **Have accountability** – The system should be “above board.” Tax rate increases and tax breaks should be transparent. Truth in taxation reports, assessments of property based on full value, and tax expenditure reports are all accountability measures.
- **Be administered uniformly and professionally** – Collecting taxes fairly and efficiently can be enhanced through compilation and distribution of tax system operations.
- **Provide an adequate level of services** – All levels of government should be able to provide an adequate level of services to meet the needs of citizens and the economic development requirements of the kind of employers a state desires to attract.
- **Minimize interstate tax competition and business tax incentives** – The system should avoid allowing businesses to play one state against another to extract tax concessions.
- **Not used as an instrument to develop social policy to encourage particular activities** – The goal is to collect revenue to support adequate services, not promote broader social or ideological goals. Tax incentives are an inefficient means of stimulating desirable actions because large portions of the tax savings go to people or business for doing what they would have done anyway.

⁶ Robert J. Kleine and John Shannon, “Characteristics of a Balanced and Moderate State-Local Revenue System, in S.D. Gold, ed., *Reforming State Tax Systems* (Denver: NCSL, 1986, pp.31-54)

CREATING ARIZONA'S FISCAL SYSTEM ADJUSTING OUR AIM

If Arizona wants to create a fiscal system that hits the target, it needs to adjust its aim. Using a multi-year approach to grow the economy and create the revenue growth rate that eliminates the structural deficit, we can arrive at an optimum system within a decade.

SEVEN AREAS ARE OFF TARGET

1. The current system is not logical. The parts of the system do not add up to a desirable whole. It has developed incrementally without an overall vision of how all the parts relate. The result is a system that is over-reliant on the sales tax, not elastic, and offers little stability. A strong consensus of what the whole will accomplish in terms of local and state services, revenues, and tax characteristics must be defined.
2. The system is not reliable. Without a fully funded and appropriately used rainy day fund, Arizona is too vulnerable to cyclical changes in revenue. Establishing the rainy day fund should be achieved in balance with investing the necessary expenditures in adequate social infrastructure needs. The rainy day fund should not be used to reduce tax rates or fund tax credits. The recent elimination of the statewide property tax removed the most stable tax source for the state and created more reliance on less stable taxes. Reduction of income tax rates resulted in too little elasticity, making it harder for the system to grow with the economy.
3. There is not enough diversification of tax sources over a broad base. The sales tax base is too narrow. Arizona's sales tax is focused on goods, and as more sales transactions occur through the Internet, the base narrows. The elimination of the sales tax on food also narrowed this base. Services are a growing portion of the economy and Arizona's tax base on services is relatively small. There are an excessive number of sales tax exemptions.
4. The system is too regressive. It is not fair to the poor and working people in our state. The state and local effective tax rate on the best-off one percent of Arizona families - with average incomes of \$869,000 - is 6.6 percent before accounting for the tax savings from federal itemized deductions. After the federal offset, the effective tax rate is only 4.9 percent (U.S. average is 5.2 percent). The average effective tax rate on families in the middle income distribution - those earning between \$25,000 and \$39,000 - is 9.7 percent before the federal offset and 9.5 percent after, nearly twice the effective rate on the very richest Arizonans. And the effective tax rate on the poorest Arizona families - those earning less than \$15,000 - is highest of all. At 12.5 percent, it is more than two and a half times the effective rate of the most well off (Attachment 2). Arizona has the 7th most regressive system in the nation. This is caused by Arizona's small income tax that fails to offset the regressivity of its sales

and excise taxes. Since 1989 tax regressivity in Arizona has worsened.⁷

5. The Arizona system offers little accountability for sales tax exemptions, business tax incentives, or income tax credits. Recent legislative studies on sales tax exemptions were inconclusive because there was no data collected on the revenues lost from the exemptions. The effect of income tax credits and other tax incentives are not monitored or reported upon, so policy makers have little data to evaluate their validity. Independent reports on the impact of income tax credits for private school tuition and public school extra-curricular contributions have demonstrated that little of the intended benefit was achieved.⁸
6. Arizona's fiscal system has no adequacy component. There is a generally held public perception and numerous reports describing Arizona's lack of adequate service in many areas including education, health services, aid to the needy, public safety, and protection of the environment. But, there are no standards for adequacy and there is no plan to address adequacy issues. These reports⁹ suggest a significant gap between adequate levels of services and Arizona's current level of services. Such a disparity suggests a more profound structural "adequacy" deficit as illustrated in Chart #2.

Chart #2 Education Fiscal Adequacy Deficit

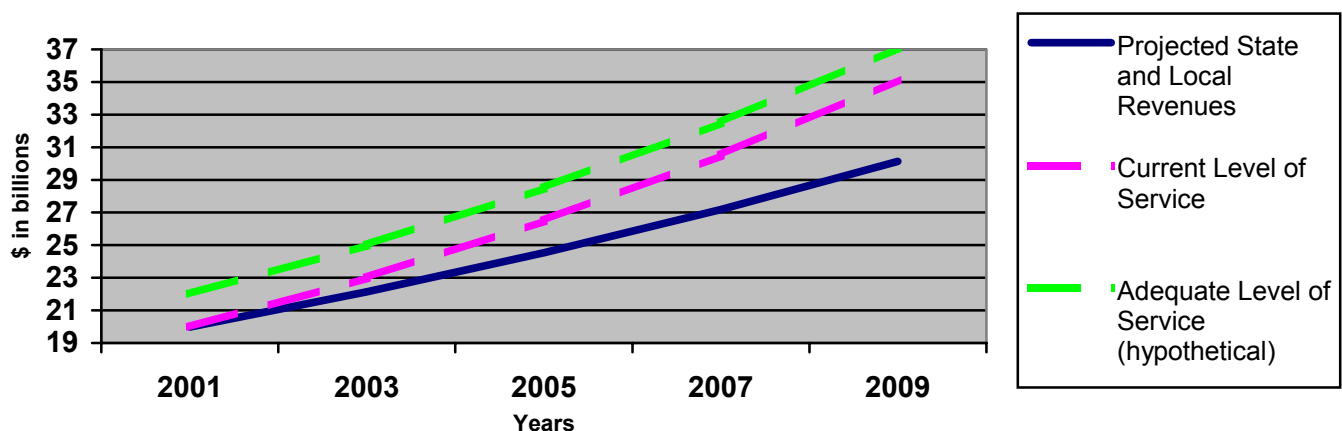


Chart #2 Education Fiscal Adequacy Deficit – The education fiscal adequacy deficit is based on an education adequacy and equity model developed by the National Education Association. The model factors test scores, spending levels, wealth, % of children in poverty and other variables. It projects an adequacy deficit of \$2.7 billion for K-12 Arizona public education. The adequacy line is labeled hypothetical because it represents one model that has not been agreed to by Arizona policy makers and represents only education. A comprehensive and Arizona-adopted adequacy model for all services would result in an actual result that could be higher or lower.

⁷ Robert S. McIntyre, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. January, 2003, Institute on Taxation and Economic Policy

⁸ Welner, Kevin G. *Education Tax Credits: Net Benefit to Arizona's Impoverished Students*. February 2003. Education Policy Research Unit, Arizona State University. <http://edpolicylab.org>

⁹ Annie E. Casey Foundation. *Kids Count 2003 Data Book*. <http://www.aecf.org/kidscount/databook>
Education Week. *Quality Counts 2002*. <http://www.edweek.org/sreports/qc99>
Morrison Institute for Public Policy, Arizona State University. *Five Shoes Waiting to Drop on Arizona's Future*. October 2001.

7. Interstate business tax competition and incentives could be improved through a more thoughtful approach. Arizona's enterprise zones have been enacted without funding or mandates to the Department of Commerce to collect data, analyze data, or report on the impact of the program. While well designed, the enterprise zones exist without an underlying strategic context for coordination of local or regional efforts. The corporate income tax is not growing with the economy as should be expected. The business property tax system seems to place a slightly higher than average burden on Arizona businesses.

A FISCAL SYSTEM TARGET

Arizona's fiscal system should be created to achieve a principled vision. Based on Arizona Education Association's scan of the current environment and research into effective tax systems, the following components are offered as a description of a preferred future system.

- Lower reliance on sales tax and/or create more reliance on a more progressive income tax for elasticity, and create more reliance on an equitable property tax for stability. This will define a logical, balanced system that distributes the burden more equitably, is stable, and grows with the economy.
- Establish a broader base of consumption taxes potentially allowing lower sales tax rates.
- Create accountability for all tax exemptions, credits, and incentives.
- Establish an adequately funded and properly appropriated budget stabilization fund
- Establish a shared definition of fiscal adequacy that provides services that create an attractive quality of life and business development environment.
- Create a simpler system for taxing businesses that provides revenues that grows with the economy.

SHOOTING THE FIRST TWO ARROWS

Taking the first steps is important as a strategy emerges. The first two steps might be focused on two short-term objectives, (1) stimulating economic growth and (2) creating the right revenue growth rate to arrive at an optimum sustainable system within the decade.

1. **Pass an economic stimulus measure that complements the long-term strategy.** Currently, Arizona is a relatively low tax state¹⁰ with a small reliance on the property tax and expenditure levels well below the national average in several service areas that, if increased, would be attractive to the public and support economic development. According to economist Tom Rex of Arizona State University, "In general, tax policy is an inefficient way to stimulate the economy. Investment in infrastructure and education has been shown to have a greater effect on economic growth."¹¹

¹⁰ Rex, Tom. Center for Business Research, College of Business, Arizona State University. *Public Finance in Arizona*. January 2003. Tempe, Arizona pp. 30-39.

¹¹ Rex, Tom. Center for Business Research, College of Business, Arizona State University. *Public Finance in Arizona*. January 2003. Tempe, Arizona p. 49.

The property tax is viewed by many taxpayers as a “school tax,” since it has traditionally been the primary revenue source for education expenditures. Students First has shifted the responsibility for providing school facilities to the state’s general fund without providing a revenue source and requires \$200 million to \$300 million in annual expenditures. Prior to Students First, the local property tax provided revenues for such school capital expenditures.

Education tops Arizona’s list of concerns by our policy makers and the public. Support for education is widespread and transcends political, social, and economic lines.¹² A report, soon to be released by the National Education Association, demonstrates that the economic expansion from increased education spending overcomes contraction from the increase in taxes and has significant positive impact in both the near- and long-term for the economies of each of the fifty states.¹³ The study shows specific economic growth effects using state-specific dynamic computable general equilibrium (GCE) models.

These factors support the establishment of a statewide property tax dedicated to funding Students First expenditures and a new widely supported education program such as full-day kindergarten, class size reduction, pre-school, child care, or an alternative education program to meet the growing diversity needs of Arizona youth.

Establishing a revenue source for Students First expenditures eliminates a major cause of the budget deficit. Each of the new education programs provides multiple positive economic growth effects and economic development value. The new property tax will provide the overall revenue system with more stability.

2. **Create the right revenue growth rate to target elimination of the structural deficit in the mid-term and the elimination of the adequacy gap in the long-term.** The gap reduction should be primarily achieved through structural changes in fiscal policies. Early study and agreement on adequacy standards will be required. Chart #3 represents this approach. As the revenue line passes the adequacy line, additional revenue could be returned to taxpayers through rebates or invested in other productive fiscal measures like the reduction of government debt rather than provide permanent tax reductions.

Specific actions need to be taken to correct the structural problems. In addition to diversifying the tax system by adding a statewide property tax, some overall revenue neutral measures need to be packaged together. A simpler and more elastic corporate franchise tax should be considered to replace the current corporate income tax. The franchise tax would use actual worth of the business as a basis for taxation rather than taxing on its profit margins. Personal income tax rates and brackets should be adjusted to build in more progressivity and capture greater amounts of revenue as the

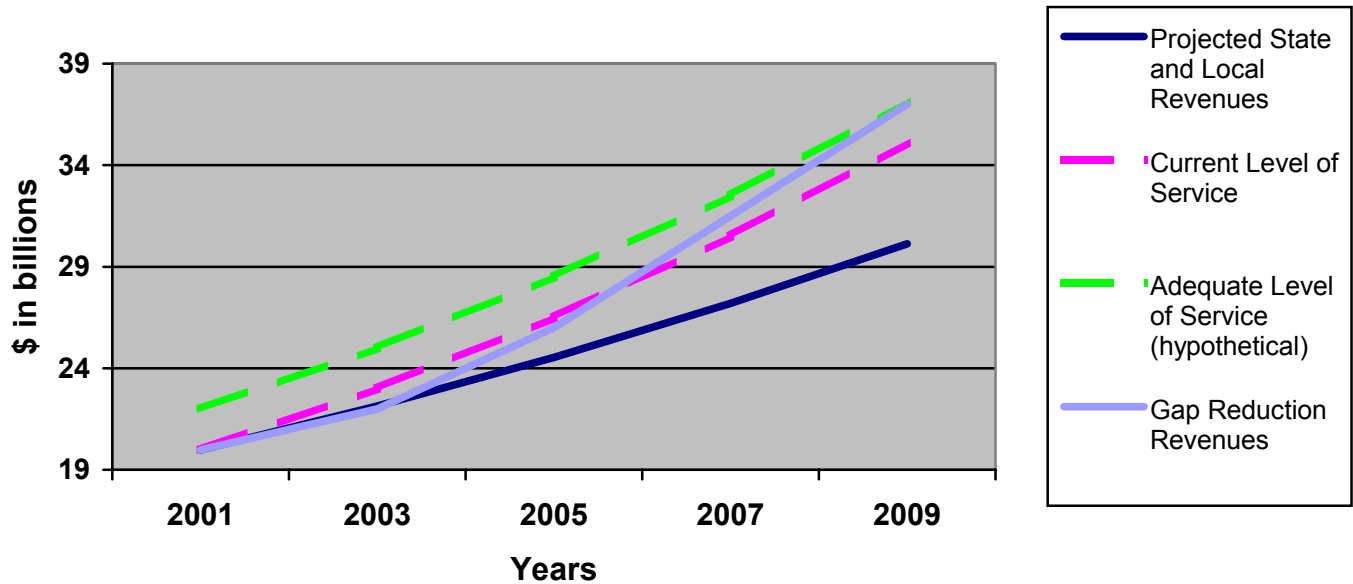
¹² David Burnori, in “Good Politics – Tax Increases for Schools” *State Tax Notes*, February 21, 2000, noted that of five major tax bills introduced to support education funding, four were introduced by Republicans.

¹³ Richard G. Sims. Project for the National Education Association. School Funding, Taxes and Economic Growth: An Analysis of the Fifty States. (Prepublication draft cited with permission of the author)

economy grows and counter balance our currently regressive system. A broader set of consumption taxes should be established, resulting in lower overall sales tax rates.

The result of this package of modifications to the personal income tax, consumption taxes, and business taxes should be a revenue neutral system with less overall dependence on the sales tax and greater progressivity and elasticity.

Chart #3 Deficit Gap Reduction Slope



SPECIFIC FISCAL POLICY REFORM RECOMMENDATIONS

The following recommendations are offered as a logical package of measures that if implemented in whole would create a fiscal system that achieves economic growth over the long term. Discussion and communication about the individual measures, without regard to the context of the whole proposal, is discouraged. This package of fiscal measures is not the only one that will achieve the results Arizona wants. AEA encourages the Citizens Finance Review Commission to consider these recommendations in concert with other views in order to achieve the mission that it is charged to complete.

1. Establish a shared definition of adequacy and a set of standards for Arizona's tax system.

- 1.1. The CFRC should use the NCSL Standards included in this report as a starting point to develop and adopt an Arizona-specific set of fiscal standards to guide policy development.
- 1.2. The CFRC should develop an Arizona-specific process to define adequacy to be completed by January of 2004. Fiscal adequacy processes have been developed in several states. Such a process is dynamic and will provide an ongoing definition of adequate service levels to create the economic development climate and quality of life our state desires.

2. Create a logical package of structural changes.

- 2.1. Broaden the consumption tax base and reduce sales tax rates in a revenue neutral manner – eventually a reduction of the overall reliance on sales taxes can be achieved as a larger proportion of overall revenue is generated by other sources.
 - 2.1.1. Broaden sales tax to include most services, but exempt business-to-business services.
 - 2.1.2. Collect Internet sales taxes and participate in the streamline tax movement.
 - 2.1.3. Evaluate the sales tax exemption on food and consider instituting all or part of the tax based on that evaluation. If this reform can be achieved in a way that provides low income residents with a lower overall effective tax rate, AEA and others will be more likely to support it because it will be viewed as more ethical and defensible. Such a reform will broaden the consumption tax base with the addition of a more stable tax source.
- 2.2. Adjust personal income tax brackets and/or rates to increase its overall progressivity
 - 2.2.1. A revenue neutral short-term approach might be to add more brackets within higher income levels, capturing income growth more rapidly.
 - 2.2.2. An increase in the tax rates at higher brackets is also an acceptable reform to provide more progressivity in the system.
 - 2.2.3. Over time a short-term revenue neutral measure will increase reliance as compared to increased sales tax over time.
- 2.3. Eliminate the corporate income tax and replace it with a corporate franchise tax.

- 2.3.1. It has long been argued that the corporate income tax discourages profits. A franchise tax would not do so.
 - 2.3.2. The corporate income tax has not proven to be as elastic as predicted and allows corporations to use legal means to shift profits to non-taxable regions through business reorganization. A simpler franchise tax that bases the tax on the value of the corporation is more stable and transparent.
- 3. Increase reliance on property taxes and stimulate the economy, reduce the structural deficit and balance the system.**
 - 3.1. Institute a statewide property tax with an exemption on the first \$50,000 of property value and equal assessment ratios to eliminate the general fund capitol school funding deficit and stimulate the economy through job growth.
 - 3.1.1. Fully fund Students First with a statewide property tax that adjusts rates based on capital needs.
 - 3.1.2. Fund one of the suggested education programs (full-day kindergarten, class size reduction, pre-school, child care, or alternative education programs to meet the growing diversity needs of Arizona youth) with the new statewide property tax. Considering Arizona's current level of services and low tax burden, the jobs created will produce greater short and long term economic growth than a tax cut designed to stimulate the economy.
 - 3.1.3. Establishment and structure of a new property tax should take into consideration the impact on businesses and homeowners and be done within the parameters of establishing an equitable distribution of the tax burden.
 - 3.2. Eliminate the general fund obligation component of the truth-in-taxation law or require its enactment each year tied to revenue adequacy needs. The reporting component provides transparency, but the general fund obligation counteracts the stability of the property tax as a part of the overall system. If tax rebates become desirable due to the generation of more than adequate revenue to meet adequate service standards, the general fund property tax can be rebated through the truth and taxation method.
 - 3.3. Base all property tax on the actual value rather than the net adjusted value. Rates would be adjusted for revenue neutrality, but the system would become more simple and transparent.
- 4. Establish and fully finance a budget stabilization fund with a goal of 10% of the general fund.**
 - 4.1. With a more logical overall system that includes more reliance on the property tax, a 10% reserve should be adequate to meet cyclical requirements.
 - 4.2. Change the operation of the budget stabilization fund to a formula driven system. Ensure that the formula does not rely on inadequate funding of government services to provide revenue growth into the fund. Ensure the fund is protected from any use other than supplying revenue to maintain adequate services during economic cyclical downturns.

5. Provide more transparency and accountability as a basis for elimination of non-productive tax policies as part of the ongoing fiscal system.

- 5.1. Institute a biannual local and state tax expenditure report and establish a cost/benefit analysis system based on tax system standards and adequacy targets.
- 5.2. Evaluate sales tax exemptions, overall business tax burden and competitiveness, income tax credits, and other specific exceptions to the basic tax code based on the state's adopted fiscal system principles.
 - 5.2.1. Samples:
 - 5.2.1.1. Tax credit for extra curricular activities
 - 5.2.1.2. Enterprise zone for businesses
 - 5.2.1.3. Sales tax on health club membership
- 5.3. Based on evaluation results, consider instituting elimination of certain sales tax exemptions, elimination of certain income tax credits, state-level coordination provisions for corporate re-location incentives, reduction of the 25% assessment ratio on business property or other adjustments to the business property tax.
- 5.4. The revenue effect of such reforms should be complemented with other tax rate adjustments.

SUMMARY

The leadership of the Arizona Education Association believes that the implementation of the package of recommendations in this report will produce positive results for Arizona. This package of reforms will provide for a future fiscal system that:

- Will operate on a defined level of adequacy
- Grows with the economy
- Distributes the tax burden more evenly and protects low and middle income families
- Is stable and responsive
- Will have adequate reserves to carry us through cyclical downturns
- Supports an economic development climate that will attract businesses to Arizona that provide high wage jobs, while encouraging the expansion of current Arizona businesses
- Is simple and transparent

This package of recommendations is one strategic approach that we believe has merit. AEA is ready and willing to join other business, civic, and political leaders in forging a consensus to set a new course for Arizona through the development, adoption and ongoing improvement of a principled fiscal strategy for Arizona.

ARIZONA EDUCATION ASSOCIATION

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ATTACHMENT 1

NATIONAL EDUCATION ASSOCIATION RESOLUTION A-22. TAX REFORM

The National Education Association supports tax reform and believes that it should –

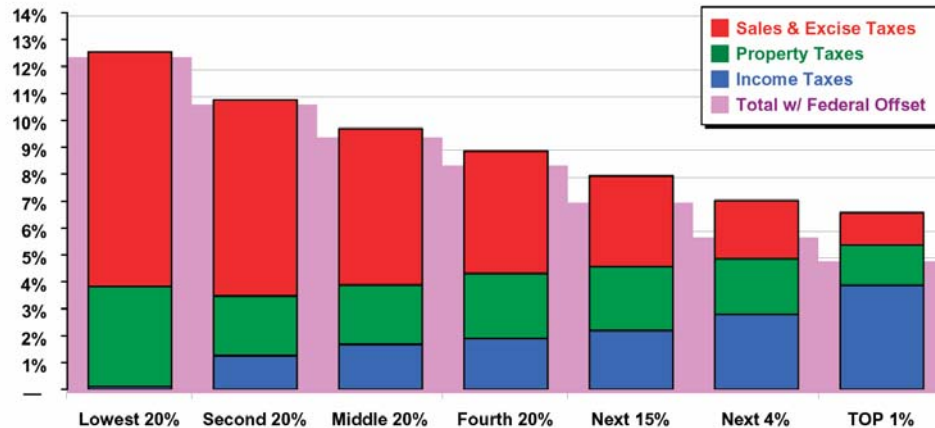
- a) Increase tax fairness and raise revenue necessary to finance quality public education and other public services
- b) Prevent excessive reliance on property tax or any other single tax
- c) Reflect the findings of comprehensive studies of the total individual and corporate tax burden
- d) Assure a tax burden distribution that reflects the ability to pay and that safeguards family subsistence
- e) Assure that statewide uniformity in property tax effort is required
- f) Provide for increased local and state funding of public education
- g) Not be used to place arbitrary maximum limits on any state or local government's ability to spend or tax, particularly since such limits have negative impact on the full funding of schools
- h) Eliminate tax laws and rulings that are harmful to education employees and educational needs.

ATTACHMENT 2

Arizona

State & Local Taxes in 2002

Shares of family income for non-elderly taxpayers



Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	TOP 1%
Income Range	Less than \$15,000	\$15,000 – \$25,000	\$25,000 – \$39,000	\$39,000 – \$65,000	\$65,000 – \$127,000	\$127,000 – \$237,000	\$237,000 or more
Average Income in Group	\$9,500	\$20,200	\$31,100	\$50,900	\$86,600	\$168,200	\$868,600
Sales & Excise Taxes	8.7%	7.3%	5.8%	4.5%	3.4%	2.2%	1.2%
General Sales—Individuals	4.5%	4.2%	3.5%	2.8%	2.2%	1.4%	0.8%
Other Sales & Excise—Ind.	2.0%	1.3%	0.9%	0.7%	0.4%	0.2%	0.1%
Sales & Excise on Business	2.2%	1.8%	1.4%	1.1%	0.8%	0.5%	0.3%
Property Taxes	3.7%	2.2%	2.2%	2.4%	2.4%	2.1%	1.5%
Property Taxes on Families	3.4%	2.0%	1.9%	2.1%	1.9%	1.6%	0.7%
Other Property Taxes	0.3%	0.2%	0.3%	0.3%	0.4%	0.5%	0.8%
Income Taxes	0.1%	1.3%	1.7%	1.9%	2.2%	2.8%	3.9%
Personal Income Tax	0.1%	1.2%	1.6%	1.9%	2.1%	2.7%	3.7%
Corporate Income Tax	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%
TOTAL TAXES	12.5%	10.8%	9.7%	8.9%	7.9%	7.0%	6.6%
Federal Deduction Offset	-0.1%	-0.0%	-0.2%	-0.4%	-0.9%	-1.2%	-1.7%
TOTAL AFTER OFFSET	12.5%	10.7%	9.5%	8.5%	7.1%	5.8%	4.9%

Note: Table shows 2002 tax law at 2000 income levels.

ATTACHMENT 2

Arizona Details

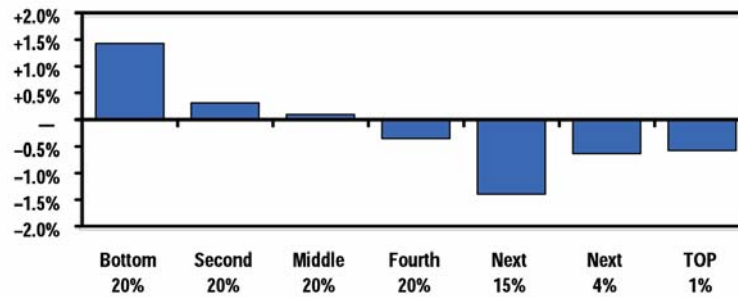
Progressive Features

- ✓ Graduated rates
- ✓ Food and most medical expenses exempt

Regressive Features

- ✗ Heavy reliance on sales and property taxes
- ✗ Income tax not indexed

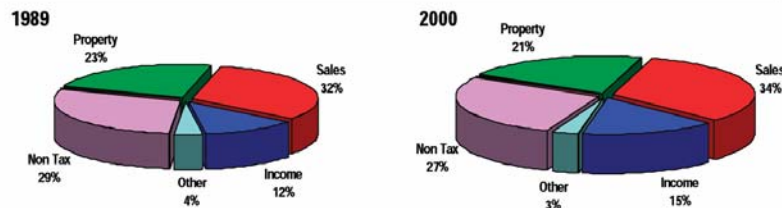
Changes in Tax as Share of Income, 1989 - 2002



	Bottom 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	TOP 1%
Sales & Excise	+1.1%	+0.5%	+0.4%	+0.2%	+0.1%	+0.1%	+0.0%
Property	+0.7%	+0.1%	+0.2%	-0.0%	-0.9%	-0.5%	-0.4%
Income	-0.3%	-0.3%	-0.4%	-0.6%	-0.7%	-0.2%	+0.3%
Federal Offset	-0.0%	+0.0%	-0.0%	+0.0%	+0.1%	+0.0%	-0.4%
Overall Change	+1.4%	+0.3%	+0.1%	-0.4%	-1.4%	-0.6%	-0.6%

Progressive changes for Arizona include the elimination of the federal tax deduction, the addition of a working family tax credit and the restructuring of the rates to make them far more graduated than they were in 1989. However, for middle and low income taxpayers, these changes were offset by large, regressive increases in sales and excise taxes.

Composition of Revenues



Source: Government Finances, US Department of Census